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Inflation and bank credit

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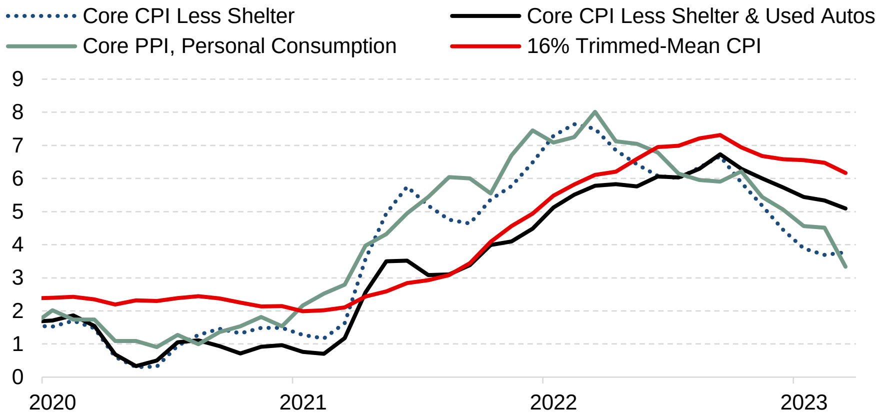
- The PPI indicates that annual inflation is coming down fast, but consumer prices present a more stubborn inflation picture. By Fed Chairman Powell's definition of "super-core" inflation (excluding food, energy, and shelter), annual price growth has fallen below 4%, but the trend has flattened since January. And if deflationary used car prices are treated as an outlier, annual inflation is at 5%. Price stability is still far from being achieved.
- The credit crunch that was expected to follow the bank collapses doesn't appear to be materializing, and the Fed may need an additional interest rate hike to compensate. However, aggressively fighting inflation could come at the expense of small banks. Commercial and industrial loans from small banks have stabilized in the early weeks of April, but they make up a declining share of overall bank credit. Real estate loans are growing as a percentage which puts small banks at greater risk if demand dries up or if defaults rise.

Inflation is likely not falling fast enough

The inflation picture changes a bit depending on which data is being observed. The Producer Price Index (PPI), which measures changes in prices received by domestic producers, shows strong disinflation both for goods and services. Intuitively, lower producer prices should lead to lower consumer prices, but the PPI and CPI differ both conceptually and definitionally.

Using the Fed's informal definition of "super-core" inflation (less food, energy, and shelter), the PPI index that most closely aligns with the CPI is the core Personal Consumption PPI (less food and energy). Both series show that annual inflation peaked in early 2022 at around 7-8% and they have both fallen to below 4% as of March 2023. But these definitions may be giving too much weight to outliers such as used car prices which has been strongly disinflationary in the last 6 months.

Inflation remains stubbornly high when excluding outliers
CPI, annual change, %



Source: BLS, Cleveland Fed, MUFG Bank Economic Research

To eliminate the impact of outliers more rigorously, the Cleveland Fed developed the 16% trimmed-mean CPI. Using this measure, inflation is falling much more slowly with annual price growth at 6.2% as of March 2023, down from the peak of 7.3% in September 2022. Any way you slice it, price stability has yet to be achieved. The CPI figures as of March suggest that an additional interest rate hike may be necessary to curb demand and underlying price growth.

Too many eggs in one basket

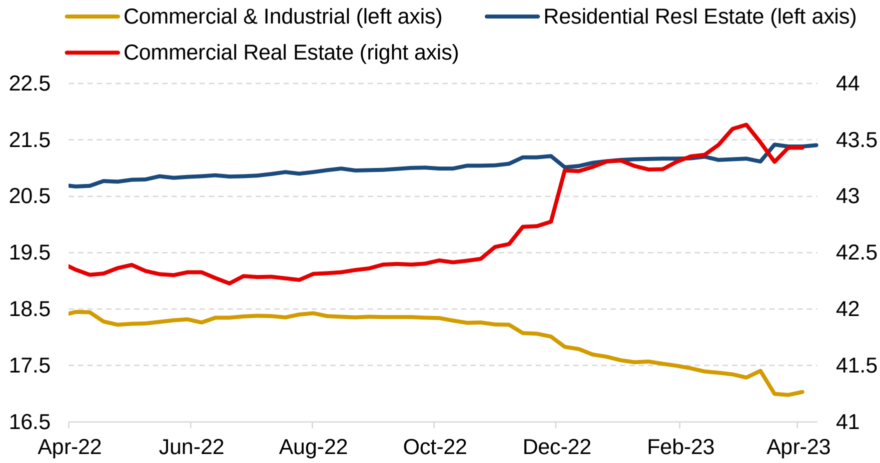
The bank collapses in mid-March are expected to lead to a credit crunch as banks become more risk averse. This would certainly lead to disinflation of asset prices with less money flowing to riskier asset classes, and likely even to consumer prices, making the job of the Fed easier in that regard. However, there are already signs that this expected credit crunch may have been short lived.

The initial fallout was concentrated in small banks, where deposits fled to large banks that were perceived to be financially stronger and to money market funds where returns are higher. In just one week, commercial and industrial loans from small banks fell by 25 trillion as credit conditions tightened in an effort to maintain higher reserve balances.

The weekly deposit outflow has since stopped, and commercial and industrial loans from small banks has been flat in the early weeks of April. So far, weekly changes in bank assets suggest that the worst is over and that the credit crunch has been largely contained to just the second half of March, but it may be too soon to tell for sure. If this is the case, then the Fed may raise interest rates another 25 basis points in May.

There are still risks to small banks nevertheless, but it has less to do with deposit runs and more to do with their loan portfolio. Consumer and industrial loans constitute a declining share of small bank assets, likely because rising interest rates are finally weighing on demand in the economy. The Fed's aggressive fight against inflation has small banks leaning on real estate to increase the size of their loan portfolio.

Real estate loans are a growing share of small bank assets
Share of bank loans for small commerical banks, %



Source: Federal Reserve, MUFG Bank Economic Research

Real estate loans are growing in share and now constitute nearly 65% of all small bank loans. Residential real estate makes up about a third of all real estate loans made by small banks, and demand has been steady despite declining home sales. Existing single-family home sales declined by about 2 million in 2022, but the value of residential real estate loans has been maintained due to high housing costs. Sales have rebounded a bit in 2023 and are around 4 million as of March.

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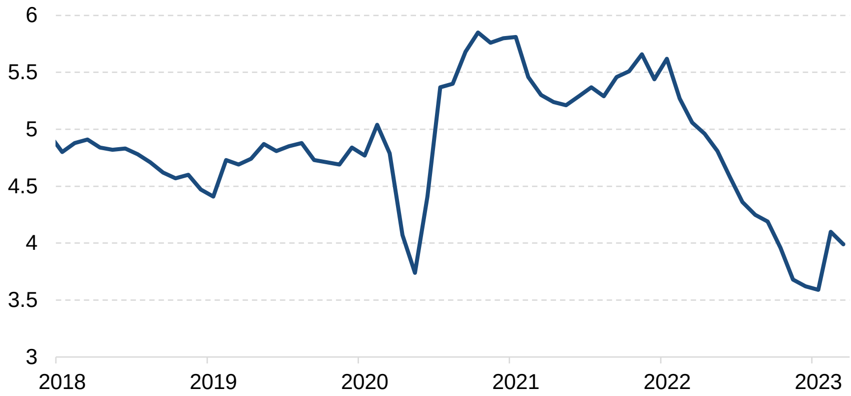
Some recovery in home sales in 2023

Existing home sales, single-family, millions



Source: NAR, MUFG Bank Economic Research

The significant housing shortage will likely prevent a crash in home prices, meaning small banks can continue to profit off residential real estate loans even as demand stays relatively low. Commercial real estate, on the other hand, poses a more serious risk.

Opposite that of residential real estate, there may be a glut in commercial real estate which can impact prices significantly. Office vacancies in major cities remain low relative to pre-pandemic rates and there is unlikely to be a surge in demand anytime soon. If prices are driven down from consistently low demand, which would be exacerbated by even a mild recession, then small bank assets and profitability off those assets would shrink considerably. Potential for rising defaults also adds to the risk, but the data isn't showing that to be a factor yet.

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